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UNCLAS SECTION 01 OF 03 BUCHAREST 001035

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SUBJECT: TAX REVENUES IN ROMANIA SHOW IMPRESSIVE GROWTH IN
FIRST QUARTER OF 2005

REF: BUCHAREST 000130

SENSITIVE BUT UNCLASSIFIED

SUMMARY

1. (SBU) Romania's budget revenues soared in the first three months of 2005. Embassy attributes this to a variety of factors, including unexpectedly high GDP growth in 2004, wider general tax compliance (perhaps linked to the new flat tax) and the threat of increased tax collection enforcement. However, corrupt mid-level managers continue to compromise tax collection efforts within the fiscal authority. End Summary

Higher Tax Revenues.

2. (U) According to preliminary data released in early April by the Ministry of Finance (MOF), first quarter consolidated budget revenues grew to nearly Romanian Lei (ROL) 177.9 trillion, or approximately \$6.3 billion up from nearly ROL 153.2 trillion, the equivalent of \$4.7 billion, during the same period in 2004. The MOF stated that revenues increased more than ROL 8.38 trillion in January, ROL 5.39 trillion in February, and ROL 10.94 trillion in the first 23 days of March 2005 when compared with the same period in 2004. The aggregate three-month increase over the same period in 2004 amounted to ROL 24.7 trillion, the equivalent of \$1.5 billion. The MOF believes in the sustainability of these trends, and points to the elimination of tax relief and tax rescheduling options as one reason for optimism. The GOR also claims to see an overall widening of the tax base due to a mix of economic growth and conversion of grey market revenue to the legitimate economy.

.Above Budget Forecasts

3. (U) These higher revenues came in above the previous government's planning targets for 1Q 2005, in spite of the flat tax. Forecasts made in 2004 predicted consolidated budget revenues for the first quarter 2.6 percent lower than actual results. Corporate profit tax collection was up 13.9 percent from projected, although the lower tax on personal income resulted in numbers 7.1 percent lower than initially expected. The increase in revenues from corporations was likely due both to greater enforcement and unexpectedly high growth. Other areas that benefited from tighter policing include customs, with revenues up 16.1 percent from projected, and VAT collections, up 5.0 percent. Revenues from excise taxes were lower than planned, mainly due to the GOR's January 1 elimination of excises on certain categories of electronic goods, such as digital cameras. This decision was later repealed in March after conversations with the IMF. Municipal contributions to the GOR budget also exceeded projections by 9.4 percent.

4. (U) The previous government based its 2005 tax revenue projections on an estimated GDP growth rate of 5.3%. However, the Ministry of Finance has not yet calculated growth for the first quarter to determine how it compares with projected. Without this statistic, it is not possible to determine to what extent increased tax revenue is a result of unexpectedly fast economic growth versus greater tax collection efforts.

Flat Tax Starting to Show its Effects?

5. (U) Another factor contributing to increased tax revenues may be the "flat tax" that is now in effect. On December 29, 2004, the new Romanian coalition government passed an emergency ordinance fulfilling its campaign promise to implement flat personal and corporate tax rates effective January 1, 2005. The new government hailed this 16 percent tax as a method of attracting foreign investment, boosting job growth and remaining competitive as Romania approaches EU membership in 2007. Excluding Georgia (12 percent), the

flat tax on corporate profits is the region's lowest.

16. (U) According to common economic wisdom, the imposition of a flat tax should cause a dip in income tax revenues for a time before showing a rise. The data from the first quarter of 2005 show glimmers of this. For example, an expected decrease in revenues from individual tax payers was evident, but much less severe than many analysts predicted, considering the ten percentage-point average drop in personal tax rates due to the flat tax. The possibility, however, that 2004 taxes (at the higher tax rates) were being paid into the GOR's coffers in 2005 make the picture too uncertain to make any explicit linkages to the flat tax at this point.

Government Clamp-Down on Tax Dodgers

17. (U) A third element in increased 2005 revenues is probably the "fear factor." President Basescu has made the fight against corruption a matter of national security and the GOR has initiated a flurry of investigations against high-profile "businessmen." Pragmatism also drives the anti-corruption strategy, since the GOR is faced with increased spending requirements in preparation for EU membership in 2007 and lower tax rates must necessarily go hand-in-hand with increased tax enforcement.

18. (U) To this end, on April 7, the GOR approved a draft law making tax evasion equivalent to a felony crime. This legislation, now being debated by the Senate Budget and Legal Commissions, imposes jail sentences for tax evaders on a clear sliding scale, leaving little room for creative court interpretation. Penalties increase based upon the amount owed. Three to ten years of prison is prescribed for those owing at least EURO 10,000; four to 12 years for those owing at least 100,000 Euros; five to 16 years for those owing at least 500,000; between 10 and 20 years for those at least EURO 1 million; and 3 to 15 years for those making illegal VAT reimbursements. Persons barring fiscal authorities from inspecting corporate property would be punished though jail terms ranging from six months to three years.

19. (U) When the Senate Commissions complete their debates, the draft law will arrive in the two houses of Parliament for further debates and revisions. Once the law is passed, it would normally come into force within thirty days, unless the Parliament decides upon a longer transition period.

U.S. Department of the Treasury Advisors Propose Changes

10. (SBU) Romania welcomes USG ideas on how to move from the theory of tax collection to practical methods of enforcement. Members of the U.S. Department of the Treasury's Office of Technical Assistance from March 28 to April 8, traveled to Bucharest to review the MOF's methods of collecting tax revenues. The team identified ways to increase tax receipts quickly by improving the collection process. Suggestions included sending letters to delinquent tax payers threatening seizure of property for nonpayment, focusing GOR resources on the highest monetary value cases, expanding the use of installment agreements and ceasing to waste efforts on unsalvageable cases. More ambitious ideas include legislative changes to limit taxpayer ability to contest minor government errors and the augmentation of MOF authority to seize assets and proceed against managers responsible for non-payment of taxes of a legal entity.

11. (SBU) MOF Secretary of State Sebastian Bodu who heads up the Agency for Fiscal Administration (AFA) concluded that the GOR could implement some of the recommendations, although he rejects installment payments in a nod to the IMF's more conservative fiscal policies. Mr. Bodu is most concerned, however, about the corrupt mid-level managers that persist throughout the fiscal administration agency, and is frustrated with his inability to clean house due to restrictions on firing civil servants. He hopes to create an internal investigation unit, partially composed of law enforcement officers, in an attempt to examine reports of employee malfeasance. If created, this unit would have the authority to arrest those suspected of corruption.

Comment

12. (SBU) Post is encouraged by the preliminary three-month tax collection data, although a longer time horizon is necessary to formulate a solid opinion on sustainability and the true full effect of the imposition of the flat tax. In addition, the GOR made amendments to the fiscal code in March which raised taxes on banking interest, capital gains, and real estate gains beginning in the second quarter. A number of excise taxes also increased on April first. Thus, three to six months of additional data are needed to come to meaningful conclusion. Nonetheless, Post is cautiously optimistic that revenues will continue to climb since Romania seems to be in a solid growth mode.

13. (SBU) An even larger problem looming for the GOR, however, is the continuation of a high level of mid-manager corruption within the AFA. This will continue to impede tax collection efforts until Mr. Bodu is given the necessary tools for reform. Post recently held an interagency brainstorming session to identify ways to assist the AFA and offer training and suggestions; several ideas were proposed and their feasibility is currently being investigated.

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